

**Compact Art. IV.1(a) (Definition of “Business Income”)
FOR DRAFTING GROUP DISCUSSION PURPOSES ONLY
Policy Checklist and Draft Amendments
February 13, 2012**

Policy Checklist with Subcommittee Answers

The Uniformity Committee answered the Drafting Group’s policy questions as follows:

1. Should “business income” include both a transactional and a functional test?
 - **YES**
2. If “business income” includes a functional test, should that test encompass income from cessation or liquidation of a business or line of business?
 - **YES**
 - a. Does it matter whether the transaction is a deemed liquidation under 338(h)(10) or an actual liquidation?
 - **NO**
 - b. Does it matter how the gains are used?
 - **NO**
3. Functional income is currently described as “income from tangible and intangible property if acquisition, management and disposition of property constitute integral parts of the taxpayer’s regular trade or business operations.”
 - a. Would it be clearer to state the test as “acquisition, management ~~and or~~ disposition of property constitutes ...?”
 - **YES**
 - b. Should other terms be included, such as “employment” and “development?”
 - **Employment – Yes; Development – Yes**
 - c. Both the transactional and functional tests use the word “regular.” Is it clear that “regular” does not limit the functional test to frequent events, or does this need to be clarified? The California Supreme Court explained in *Hoechst Celanese*: “In the transactional test—which focuses on the income-producing transaction—‘regular’ modifies ‘course of the taxpayer’s trade or business’ and makes the nature of the transaction relevant. In the functional test—which focuses on the income-producing property— ‘regular’ modifies ‘trade or business operations’ and follows the phrase ‘an integral part of.’ Consequently, ‘regular,’ as used in the functional test, does not refer to the nature of the transaction, and the extraordinary nature or infrequency of the income-producing transaction is irrelevant.” Could the term “regular” be eliminated from the functional test?
 - **YES, Eliminate “regular” from functional test.**
 - d. The term “integral” is the touchstone for determining whether property has a close enough relationship to the taxpayer to satisfy the functional test. But is the term clear or is it needlessly vague? In *Hoechst Celanese*, the California Supreme Court explained that interpreting “integral” as “contributing to” could be unconstitutionally broad, while interpreting “integral” as “necessary to” or “essential to” would be too restrictive

(since no asset would be sold if it were necessary or essential). The Court found that “integral” should be construed somewhere between these two – e.g., “*materially* contributing to.” Another option would be to use the language of the U.S. Supreme Court in *Allied Signal* and require that the property from which the income arises is “operationally related to” or “related to the operation of” the taxpayer’s business.

➤ **NO**

e. Should “tangible and intangible property” be replaced with “property or assets?”

➤ **NO**

4. If “business income” includes both functional and transactional tests, and includes gain/loss from cessation of business,

a. Is the intent to encompass all income apportionable under the U.S. Constitution?

➤ **YES**

b. If so, should that be stated in the statute? Tying the statutory definition to the scope of the constitution is not very specific guidance, and may introduce some additional uncertainty, on the one hand. On the other hand, the absence of such a statement could result in an interpretation that is something short of the constitutional scope. Is the more important goal increased clarity or full apportionment?

➤ **YES, but instead of “to the extent,” use a phrase that sounds less like a limitation, such as “all income apportionable under.”**

c. Would it be useful to retitle “business income,” e.g., as “apportionable income” or “unitary income”?

➤ **MAYBE; Review UDITPA**

5. Is it necessary for the statutory definition to explicitly anticipate the potential for a single taxpayer to operate more than one “trade or business”? Or, because that concept is a constitutional requirement, is it sufficient that that it be addressed, as it is now, in regulation?

➤ **NO**

Draft Language

CURRENT UDITPA:

Art. IV (1)(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of property constitute integral parts of the taxpayer's regular trade or business operations.

Art. IV (1) (e) "Non-business income" means all income other than business income.

DRAFT FROM LAST WEEK:

- A: Art. IV (1)(a) "~~Business-Appportionable~~ income" means all income that is apportionable under the Constitution of the United States, and includes:
- (i) income arising from transactions and activity in the regular course of the taxpayer's trade or business, ~~and includes~~
 - (ii) income arising from tangible and intangible property if the acquisition, management, employment, development, or ~~and~~ disposition of the property constitute integral parts of is or was related to the operation of the taxpayer's regular trade or business operations.

ADDITIONAL CHANGES TO DRAFT (to address apportionment of non-unitary domiciliary income):

B: "Apportionable income" means all income that is apportionable under the unitary business principle of the Constitution of the United States, and includes:..

C: "Apportionable income" means all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, and includes: ...

D: "Apportionable income" means all income that is apportionable under the unitary business principle of the Constitution of the United States and is not allocated under the laws of this state, and includes: ...

OR

E: "Apportionable income" means:

- (i) all income that is apportionable under the unitary business principle of the Constitution of the United States, ~~and includes including:~~
 - (A) income arising from transactions and activity in the regular course of the taxpayer's trade or business, and
 - (B) income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business; and
- (ii) any income that is allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to [cite state statute]

AND: Art. IV (1) (e) "Non-~~business-apportionable~~ income" means all income other than ~~business~~ apportionable income.